CURRENTS

WESTERN CANADA'S
ECONOMIC BULLETIN

FEATURE STORY

Why floods and other natural disasters are "good" for the economy

CANADA WEST FOUNDATION AUGUST 2013

THE NEW NORMAL?

Slower growth in China

GLOBAL ECONOMY

CANADIAN HEAD OFFICES

Which city has the highest concentration?

BEHIND THE NUMBERS

ENERGY PRICES RISE

Softening the blow in flood-ravaged Alberta

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GLOBAL ECONOMY

Tempering expectations in China

MICHAEL HOLDEN, SENIOR ECONOMIST

Economists continue to moderate their forecasts for the global economy as they reset their expectations for growth in China and other developing markets. Most recently, in its July 2013 *Monetary Policy Report*, the Bank of Canada revised its expectations for global growth to a modest 2.8% this year, compared to 3.0% in its April forecast. Slightly slower growth is now expected in 2014 and 2015 as well.

The good news is that the global economy is growing and that the troubles plaguing the world's advanced economies seem to be easing. The US continues on the road to recovery. The EU appears to be stabilizing and the Japanese economy is showing signs of life.

The problem is that China and other emerging economic powerhouses appear to be settling in to a period of more modest expansion. Of course, even growth that's "modest" in China dwarfs the best that most other countries could hope for. The Chinese economy is still expected to grow at about 7.3% to 7.5% annually through 2015, more than three times as quickly as Canada. However, this is well off the torrid pace of expansion in China over the last decade. From 2003 to 2012, the Chinese economy grew by an average of 10.5% every year.

Two main factors are contributing to slower growth in China. First, the Chinese economic boom has been driven by exports and capital investment, both of which are abating in the face of reduced global demand. Related to the investment issue, China is also tightening access to credit as part of a series of reforms aimed at improving the stability of the financial sector.

The repercussions of slower growth in China and other emerging economies are being felt around the world, including in western Canada. Softer demand is weakening global commodity prices, especially for base metals and minerals. While prices for those commodities remain well above historic levels, they have been falling more or less steadily since late 2010. In the first half of 2013 alone, prices have dropped by nearly 11%. Forest products have also turned down since April, wiping out five consecutive months of gains in a sector which has for years struggled against flat prices.

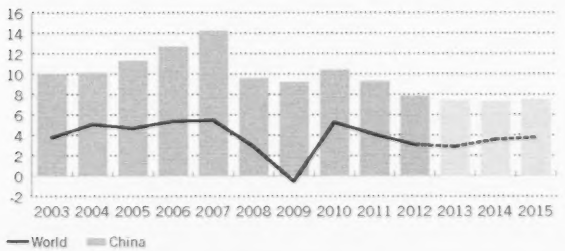
Western Canada's overall exports to China continue to expand rapidly, but there is little doubt that slower growth in China has sapped some of the momentum. From January to May 2013, western Canada's total exports to China were up about 12% compared to the same period last year. A healthy rate of growth to be sure, but this is well below the 22% per-year average increase since 2009.

At least part of the blame can be pinned on base metals exports which were down 1.1% through the first four months of the year. In particular, the value of western Canada's copper, nickel and iron and/or steel product shipments to China are well below last year's levels.

Considering how much metal and mineral prices have risen over the past decade, a decline of 11% is not likely to have a major effect on the mining industry in western Canada. Only gold miners have reason to be worried, and in that case, the plunge in gold prices over the past few months is unrelated to the economic situation in China.

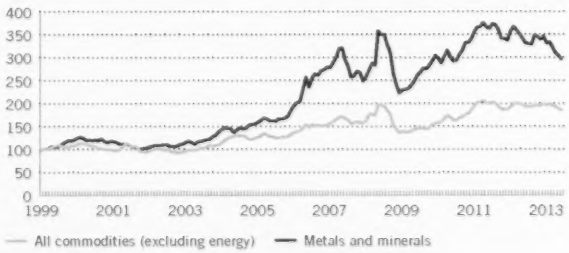
The bright side for western Canada is that structural changes in the Chinese economy will open new export opportunities. In response to the ills borne of China's export and investment led development strategy (heavy pollution and severe income inequality), the Chinese government is focusing its future policy efforts on expanding domestic demand and ushering in an era where consumers are the main engine of growth. Already, exports of western Canadian food products into China are soaring. As Chinese citizens become wealthier, other opportunities to sell consumer goods into China will appear.

A NEW ERA OF SLOWER GROWTH IN CHINA (% growth in real GDP)



Source: International Monetary Fund (IMF), Bank of Canada

GLOBAL COMMODITY PRICES TAPERING OFF (index: January 1999=100)



Source: Canada West Foundation calculations using Bank of Canada data

WESTERN COMMENTARY

Natural disasters expose flaws in how we calculate growth

The floods that swept through southern Alberta in June had a devastating effect on the region. While the impact on human lives and lost homes and livelihoods dwarf all other concerns, the floods will have a significant economic impact as well.

In the immediate term, that impact is clearly negative. It comes in the form of lost production through supply disruptions and road closures, as well as lost work hours and revenues for affected businesses. It will be especially acute given the closure of large swaths of downtown Calgary.

A little further down the road, however, the repair and reconstruction effort will actually provide an overall boost to the provincial economy. This reflects one of the quirks of our reliance on Gross Domestic Product (GDP) as a measure of economic performance. The way GDP is calculated, natural disasters such as this one often end up generating a noticeable positive short-term effect on the economy.

GDP is most commonly described as the market value of all final goods and services produced in a country (or province) in a given time period. The more we produce, buy and sell, the wealthier we are assumed to be.

GDP is a good measure of market transactions, but it is a flawed measure of economic activity. For one, it does not include the value of unpaid labour. It also reflects the benefits of output but not the costs, including resource depletion and environmental degradation. Finally, GDP fails to distinguish between positive and negative activities. War, crime and natural disasters—including the floods in Alberta—are "good" for the economy because they are catalysts for market transactions.

The Japanese nuclear disaster in 2011 provides an excellent example of this effect. When the earthquake hit in March, the economy was devastated, plunging 2% in the first quarter of the year. By the fall, however, cleanup and repairs were underway and the economy rebounded to register a 2.7% increase – Japan's single highest quarter of growth in more than 20 years.

A similar story will play out in Alberta on a smaller scale. The repair of homes, businesses and infrastructure will register as a positive economic impact. Meanwhile, the lost value of existing infrastructure will not be explicitly captured.

Further down the road, these losses will eventually be felt. For example, in pledging $1 billion in initial flood relief, the provincial government also acknowledged that it will no longer be able to balance the operating budget next year as first promised. This is effectively an implied promise of lower expenditures or higher taxes down the road.

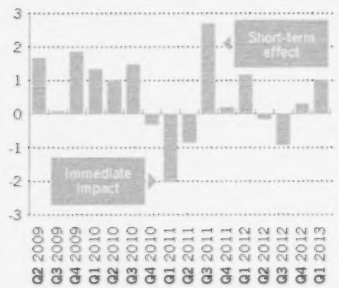
In addition, money spent on flood relief—whether public or private—does not appear out of thin air. It reflects borrowing or the reallocation of funds that would otherwise have gone to some other use. Rebuilding a flood-damaged bridge may have an immediate impact comparable to building a new one, but at the end of the day, two bridges would have been better than one. These types of economic effects are important but extremely difficult to tease out of the data we typically rely on.

THE IMPACT OF NATURAL DISASTERS

ON SHORT-TERM ECONOMIC GROWTH

JAPAN'S NUCLEAR DISASTER AND ECONOMIC GROWTH

Real GDP growth (%)



Source: Canada West Foundation, IMF

The Alberta economy is expected to grow by

2.8%

in 2013 and 3.6% next year. Before the flood, the forecast was for growth of 2.5% and 3.3%.

Source: TD Bank

BRITISH COLUMBIA

Bottoming out?

There was little in the way of good news for the BC economy through the first half of 2013. After posting tepid growth in 2012, the provincial government recently downgraded its expectations for GDP growth this year from an already modest 1.6% to 1.4%.

Slower-than-expected growth is also putting the provincial government's razor-thin budget surplus in jeopardy as it weighs on revenue expectations. In its February budget, the BC government projected a $197 million surplus (which does not include significant borrowing for capital spending), but downgraded that expectation to $153 million. Further complicating matters, that $153 figure was only achievable after the government drew down $50 million from its $200-million forecast allowance and further committed to find $30 million in savings.

BC enjoyed a welcome spike in employment in June as the economy added 8,900 new jobs. In fact, the underlying numbers were better still as the economy generated 21,600 new full time positions at the expense of 12,700 fewer part-time jobs. Gains in agriculture and trade offset steep losses in information, culture and recreation services.

One month of good jobs numbers does not a recovery make, however. Employment in the second quarter of 2013 was up only marginally over the previous quarter and remains below last year's levels. Consumer activity continues to be stagnant and, in spite of soaring energy prices, inflation in BC was negative in the second quarter of 2013 – a further indication of weak demand and excess production activity.

Sluggish economic growth in BC, especially compared to its two closest provincial neighbours, is contributing to a significant exodus out of the province. From the first quarter of 2012 through the first quarter of 2013, BC has lost more than 10,000 residents to other parts of Canada. Alberta has been an especially popular destination.

In spite of all this negativity, there are early signs that the BC economy may be close to turning a corner. In particular, the province's housing market appears to have stabilized. Resale activity has been picking up over the last few months. Meanwhile, the number of homes coming on the market has been stable. As a result, prices are beginning to recover; the average resale price in June was $525,400 – the highest level in 15 months.

In addition, industrial activity in BC has begun to pick up. After about a year and a half of no growth, manufacturing shipments have been growing since February. Exports have also been relatively strong. Thanks to a surge in sales to the United States and China, BC's total exports through May are up 5.2% compared to the same period last year.

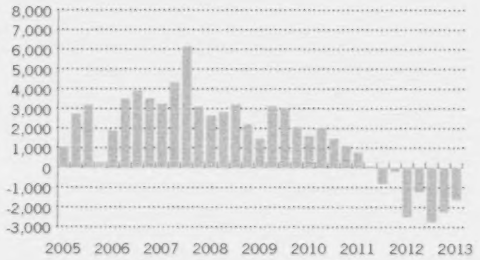
Retail sales in BC through April have fallen by

0.3%.

Across Canada, they are up 1.1%.

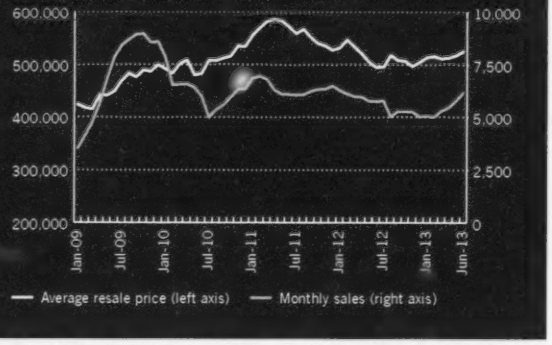
Source: Statistics Canada

NET INTER-PROVINCIAL MIGRATION (# of net migrants)



Source: Statistics Canada

BC HOUSING MARKET STABILIZING? ($ and units)



Source: Canada West Foundation using data from the Canadian Real Estate Association

ALBERTA

Picking up the Pieces

Before widespread flooding hit southern Alberta in late June, the province was enjoying a solid run of economic growth. Alberta had been by far the fastest-growing province in Canada in 2012 and the momentum was continuing into 2013. Flooding knocked the wind out of the sails of the provincial economy, causing untold damage to homes, businesses and infrastructure in the affected areas.

As the province picks up the pieces, consumer activity will be among the first to recover. Alberta was home to Canada's hottest retail market through the first five months of the year, growing at 6.6% compared to the same period in 2012 – nearly four times the national average rate. Sales will likely dip in June and into July, but are set to surge ahead in the following months. With the Alberta government promising to compensate homeowners and businesses for their losses, those impacted by the floods will not only be repairing their homes, but also buying new furniture, appliances, computers and other household goods and business equipment.

Soaring inter-provincial migration will also accelerate the economic recovery. On a net basis, Alberta welcomed more than 13,400 Canadians to the province in the first quarter of 2013 – the single largest winter migration to Alberta ever recorded. Contributing factors include recent changes to the Employment Insurance program that reduced disincentives to seek work.

The Alberta government has abandoned its deficit-elimination target because of the tremendous costs associated with flood compensation, reconstruction and investment in future mitigation. While this is undoubtedly an appropriate response to such a disaster, it will exacerbate the province's fiscal challenges in the years ahead.

On the bright side, the blow to the province's bottom line will be softened by an improving outlook for non-renewable resource revenues. Natural gas prices have more than doubled since last April, crude oil prices are rising and the price differentials that contributed to the province's $2.8 billion fiscal shortfall last year are closing. In its 2013 budget, the provincial government assumed an average price of $68.21/bbl for the Western Canadian Select (WCS) crude oil blend. Prices have been consistently above that mark since April and by late July, WCS was selling for about $87/bbl.

There is no guarantee that just because western Canadian oil prices are relatively high today that they will remain that way for the rest of the year. However, given the added fiscal burden that the floods will impose on the provincial government, an unexpected revenue windfall through the first three months of the budget year is welcome news indeed.

NATURAL GAS PRICES RECOVERING (US$/million btu)

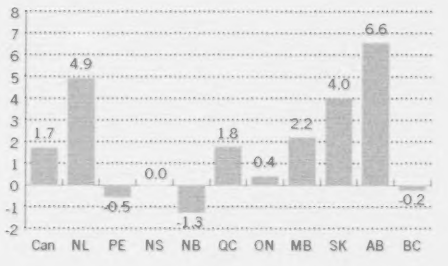
Source: Federal Reserve Bank of St. Louis

13,438

net migrants moved to Alberta in the first quarter of 2013.

Source: Statistics Canada

RETAIL TRADE GROWTH JAN-MAY 2013
(% change over Jan-May 2012)



Source: Canada West Foundation calculations using Statistics Canada data

SASKATCHEWAN

Ramping down growth expectations

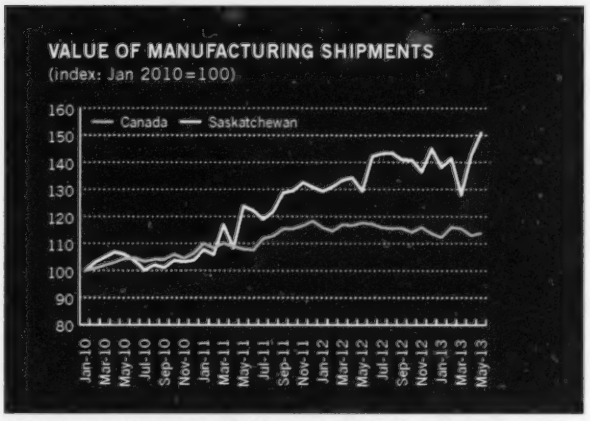
After frenetic expansion in 2010 and 2011, the Saskatchewan economy is finally slowing to a more sustainable rate of growth. Figures released in April indicate that the provincial economy grew about 2.2% last year, in part because of a slowdown in construction activity. This year looks to be stronger than 2012, but will not match the 4-5% growth of the previous two years.

Construction should continue to be a drag on the Saskatchewan economy through the remainder of 2013. Business investment intentions for this year are down and housing starts through June are 23% lower compared to the first half of 2012. Moreover, the value of building permits issued within the province is well off last year's pace. The decline is especially steep in non-residential construction.

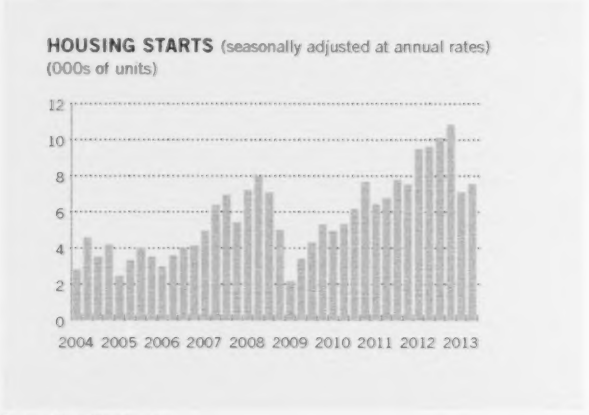
After a strong start to the year, labour markets in Saskatchewan have tapered off as well. Employment levels were essentially flat in the second quarter of the year compared to the January-March period. However, momentum will virtually guarantee that Saskatchewan will boast a strong labour market performance at year-end. Considering how rapidly employment grew last year, even if the province does not create a single new job between now and the end of 2013, employment levels for the year as a whole will still be 3.3% higher than in 2012.

Consumer activity in the province received a welcome bump this spring. Retail sales jumped 7.7% in just two months (April and May) on the strength of motor vehicle sales and a long winter which deferred spending on outdoor home equipment and materials. While a welcome reprieve from four consecutive months of decline, this surge is more likely to be a temporary blip than the beginning of a new trend. Slower employment and wage growth will dampen aggregate consumer demand. Net out-migration may play a small role as well. Although the total numbers are very modest, Saskatchewan has seen a net loss of residents in two consecutive quarters – the first time this has happened since 2006.

Although consumer markets are not as strong as they once were, Saskatchewan's producers continue to propel the economy forward. Along with energy, the manufacturing sector has been one of the major drivers of economic growth in the province. Led by machinery and food products, manufacturing grew more than four and a half times faster than the provincial economy as a whole last year. The momentum is continuing into 2013 – from January through May, manufacturing sales are up 6.6% over the same period last year. By comparison, manufacturing sales in Canada as a whole are down 1.9% over the same period.



Source: Canada West Foundation calculations using Statistics Canada data



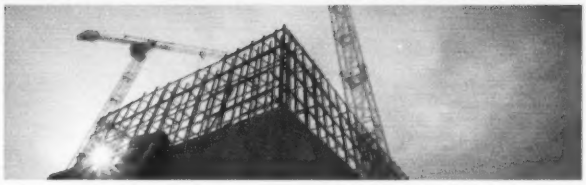
Source: Statistics Canada

In 2012, Saskatchewan passed BC to become Canada's **fourth-largest exporting province.**

Source: Statistics Canada

MANITOBA

Construction hangover?



As a stable, diversified economy, Manitoba often lacks the economic drama associated with its resource-reliant western neighbours. However, with very little fanfare, the province delivered a solid economic performance in 2012, growing at 2.7%. Alberta was the only province to post better headline numbers.

In part, Manitoba's strong growth last year was the result of a healthy snap-back performance in agriculture after the 2011 floods ravaged crops in the province. Manitoba also posted strong gains in the energy sector; GDP in oil production alone increased by 26% last year. Manitoba still produces just a fraction of the oil recovered in neighbouring Saskatchewan, but output has more than quadrupled in the past decade. Oil extraction (including support activities) now contributes almost as much to the Manitoba economy as crop and animal production.

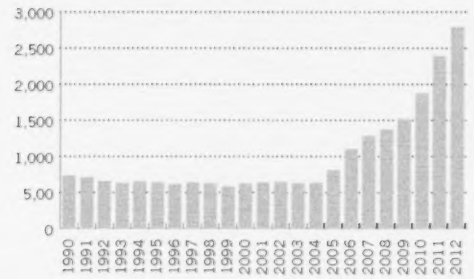
Indications suggest that the Manitoba economy will return to a more modest growth rate in 2013. Non-residential construction was a major driver of growth last year, but building permits issued from January through May of this year are 25% lower than they were in 2012. While 2012 was an excellent year for construction in Manitoba, the completion of major one-time projects like the new stadium for the Winnipeg Blue Bombers almost inevitably lead to something of an economic hangover soon after.

Manufacturing activity in the Manitoba is also flat. Monthly shipments of manufactured goods have been essentially unchanged for the last 18 months and are acting as a drag on exports in 2013. Through May, provincial exports are up just 2.0% compared to last year as higher nickel, energy and pork sales were just enough to offset lower sales of machinery and equipment, canola and copper.

On the bright side, oil extraction is expected to continue to grow through the year and agriculture prices have remained strong – welcome news for Manitoba farmers. Farm cash receipts in the province reached a record $1.8 billion in the first quarter of 2013. Crop receipts led the way with a 29% increase over the same quarter last year.

Manitoba's consumers provided the economy with a welcome boost in May, increasing by 2.3% over April levels. As in Saskatchewan, the surge in retail trade is in part the result of a late spring that led consumers to defer spending on outdoor goods and equipment until warmer weather arrived. However, underlying economic conditions on the province suggest that this increase is more likely to be a temporary spike rather than the beginning of a summer-long spending spree.

CRUDE OIL PRODUCTION (000s of cubic metres)



Source: Canadian Association of Petroleum Producers

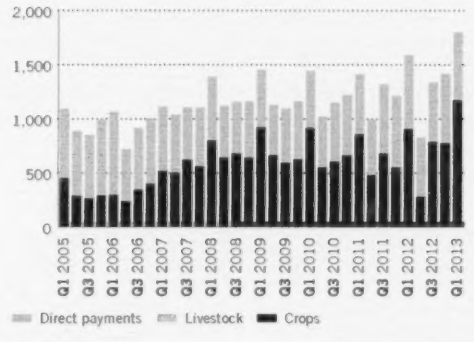
Farm cash receipts reached a record

$1.8 billion

in the first quarter of 2013.

Source: Statistics Canada

FARM CASH RECEIPTS ($ millions)



Source: Statistics Canada

BEHIND THE NUMBERS

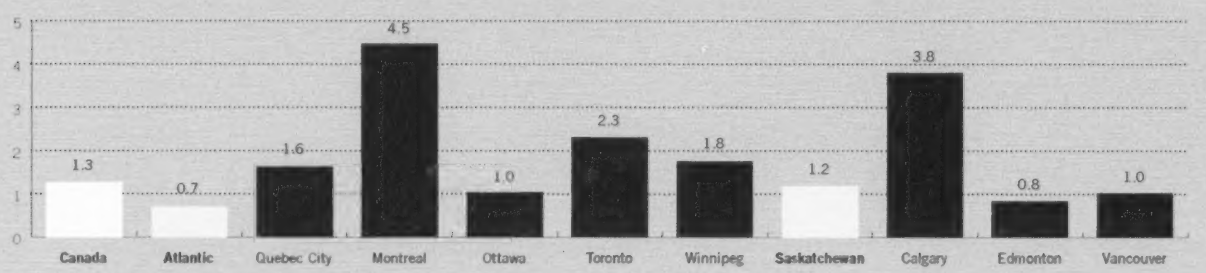
As the centre of Canada's energy sector, Calgary has the highest concentration of head offices of any major city in the country.

Although Toronto, Montreal and Vancouver all have a larger overall number of head offices, they are more commonplace in Calgary than in any other major city in Canada. With a population of just under 1.3 million in 2011, Calgary was home to 224 head offices – equivalent to 17.7 head offices per 100,000 residents. Toronto has the next highest concentration, at 12.6 per 100,000 residents.

Numbering 247 in 2011, Vancouver has slightly more head offices than Calgary, but also twice Calgary's population. There were 124 head offices in Edmonton and 91 in Winnipeg. Data are not available for Regina, Saskatoon or Victoria.

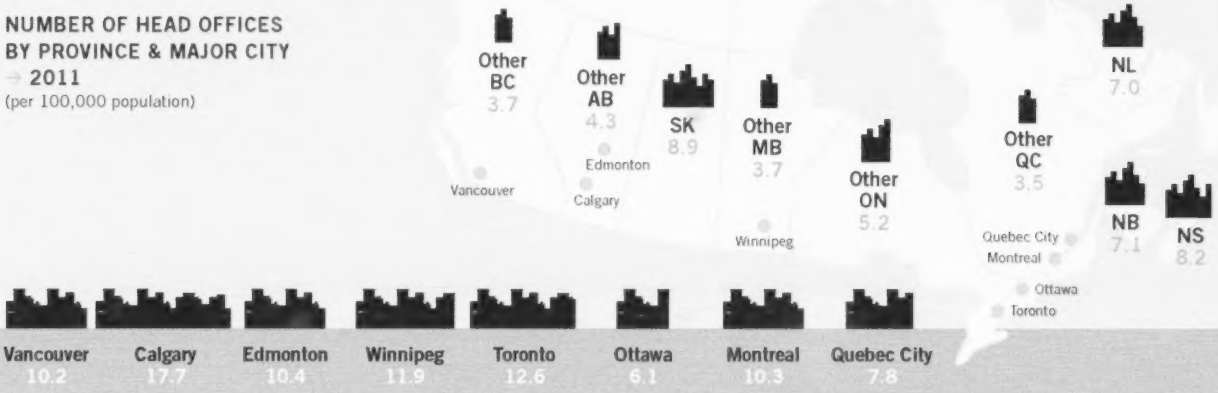
Head offices are also an important source of jobs in Calgary. In 2011, there were nearly 30,000 Calgarians employed in head office functions, accounting for 3.8% of all jobs in the city. Only in Montreal are corporate headquarters a more important employer. Within the West, head offices are also a relatively important source of jobs in Winnipeg, where they employ 1.8% of the workforce.

HEAD OFFICE EMPLOYMENT IN CANADA → 2011
(as a % of total employment)



Source: Canada West Foundation calculations using Statistics Canada data

NUMBER OF HEAD OFFICES BY PROVINCE & MAJOR CITY → 2011
(per 100,000 population)



Notes: Data are not available for the three territories and Prince Edward Island. Data for Ottawa includes Gatineau. Source: Canada West Foundation calculations using Statistics Canada data

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